March 2, 2022

Market Segment Outlook: Gulf Cooperation Council Insurance

GCC insurers have largely demonstrated the resilience of their balance sheets since the onset of the COVID-19 pandemic

AM Best is revising its market segment outlook for the insurance markets of the Gulf Cooperation Council (GCC) – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE) – to Stable from Negative. Key factors contributing to the change in outlook include the following:

- Rallying oil prices driving economic recovery across the region
- Increased opportunities for insurance sector growth
- Recovering financial markets

Near-term concerns for the segment include:

- Strong competition fuelled by large number of market participants
- Pricing pressures threatening technical margins in medical and motor
- Level of IFRS 17 preparedness uncertain

Rallying Oil Prices Driving Economic Recovery Across the Region

Most members of the GCC are heavily reliant on hydrocarbon activity to support economic growth and fiscal spending power. The Gulf economies experienced a notable economic slowdown with the onset of the COVID-19 pandemic, driven by uncertainty and simultaneous weakening of the oil price environment.

With the lifting of COVID-19 related containment measures, the resurgent demand for oil and the resultant buoyant price environment has brought economic relief to the GCC region. The International Monetary Fund (IMF) reports that all economies in the region returned to growth in 2021. This growth is projected to continue over the near term in each of the Gulf states, with gross domestic product (GDP) expected to exceed pre-pandemic levels by the end of 2022.

In late-February 2022, oil prices hit an eight-year high as Russian forces launched an invasion of Ukraine. For the first time since 2014, the price of Brent Crude exceeded USD 100 per barrel, in sharp contrast to the lows in early 2020 of USD 20 per barrel. Rising oil prices are attributed to supply concerns amid excess demand for oil, linked to increased global economic activity as countries emerge from periods of pandemic-related measures.

The economies of the GCC are highly sensitive to oil price changes, and there is a correlation between oil prices and growth in GDP. Sustained higher oil prices are expected to have a substantial impact on regional economic recovery and public spending capacity across the GCC. As at February 2022, the price of oil on a per barrel basis largely exceeded the estimated fiscal breakeven points of the GCC members. In AM Best's view increased economic activity and greater governmental fiscal manoeuvrability are positives for the insurance markets of the region.

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Increased Opportunities for Insurance Sector Growth

AM Best expects strengthening economic fundamentals to directly contribute to the demand for insurance products in the near term. Many insurance segments in the GCC observed healthier rates of premium growth over the first half of 2021, compared with 2020, when the market was heavily impacted by fiscal constraints, reduced demand for insurance products arising from COVID-19 related containment measures and affordability concerns.

For many insurers operating in the GCC, there has historically been at least a partial reliance on public spending—notably on infrastructure projects—for premium growth opportunities. A substantial proportion of commercial property and engineering risks underwritten in the GCC are linked to government-backed initiatives. Furthermore, these government-related contracts have often been highly profitable for the region's insurers, providing strong levels of inward reinsurance commission from extensive reinsurance participation.

Economic recovery across the region should drive increased expenditure on government-funded projects, concurrently leading to an increase in insurable risk and profitable growth opportunities for commercial insurance markets.

Outside of the commercial risks segments, as economic activity increases, the demand for insurance protection (particularly in core classes such as motor and medical) will also likely increase. Furthermore, near-term premium growth opportunities are highly likely to come from the implementation of long-awaited mandatory insurance schemes in several markets across the GCC. For example, Oman's compulsory medical cover is now being rolled out following implementation delays due to the COVID-19 pandemic.

However, the extent of growth potential, particularly in retail segments may be somewhat limited due to the effects of the pandemic and uncertainty over expatriate numbers.

Since the start of the pandemic, the number of expatriate workers in the region has fallen, which when coupled with a renewed focus on workforce nationalisation policies in certain GCC countries (such as Oman and Kuwait) may negatively impact insurance demand.

AM Best notes that in addition to a more supportive economic environment, innovation and digitalisation initiatives undertaken by insurers—and accelerated by the pandemic—to improve customer experience and modernise distribution channels should support growth by providing market access opportunities, particularly in personal lines.

Recovering Financial Markets

Capital requirements for insurers in the GCC are typically weighted towards asset risk as opposed to underwriting risk. Insurers in the region often carry higher-risk investment portfolios, holding a greater proportion of equity and real estate assets compared with developed market counterparts, in part as a long-term inflation hedge. This exposed balance sheets to heightened volatility in early 2020, when GCC equity markets fell by as much as 30%, and fair-value losses were booked. However, companies in the region were largely able to absorb these losses owing to the sufficient capital buffers in place.

The financial market uncertainty of COVID-19 has been easing over the past 18 months. Throughout 2021 insurers reported fair-value gains, reversing losses experienced in 2020. As financial markets have rallied, investment returns have returned as a strong contributor to overall earnings for the region's insurers, and the level of volatility has subsided.

COVID-19 containment measures and reduced demand for office space in 2020 caused additional strain to an already challenged regional real estate market, with a number of market participants booking valuation losses. Although excess supply continues to present an issue to the sector, positive movements in real estate indices and increasing demand linked to economic recovery should partially alleviate the risk of material impairments to real estate valuations for the region's insurers.

Although GCC insurers have demonstrated their ability to withstand the economic and market shocks brought on by the COVID-19 pandemic, the region remains sensitive to the potential for future pandemic-related volatility, and the longer-term impacts faced (such as supply chain distributions and inflationary pressures) as global economies recover.

Geopolitical Tensions

Geopolitical tension presents as a neutral factor to the GCC market outlook. With some easing of tensions across the region in 2021, AM Best notes the potential positive impact this could bring to the region's insurance markets, including opportunities for cross-border activity, premium growth and regulatory strengthening, as well as adding additional foreign interest in the region. However, as demonstrated by recent events, such as drone attacks in the UAE, geopolitical tension in the Gulf remains an underlying risk that needs to be managed.

Strong Competition Fuelled by Large Number of Market Participants

Insurance markets across the GCC are fragmented and competition is widespread. Large numbers of insurers operate in each market, competing for limited available insurance premiums. Furthermore, the most competitive lines—medical and motor—make up the majority of net written premium across the region.

Merger and acquisition (M&A) activity is becoming an increasing feature in the GCC insurance markets. Despite transaction numbers being down in 2021 compared with 2020, further M&A activity is expected over the near term.

In AM Best's view, further consolidation could be seen as a tailwind for the GCC's insurance markets, potentially improving market profitability by reducing pricing competition, driving operational efficiencies from economies of scale and providing inorganic growth opportunities. However, extensive M&A activity at a level sufficient to alter the competitive landscape may only follow regulatory intervention, for example, from the imposition of increased minimum capital requirements.

Pricing Pressures Threatening Technical Margins in Medical and Motor

Competitive conditions have been exacerbated by the strong underwriting performance reported by the region's insurers in 2020. Lower claims frequency in medical and motor classes during the pandemic boosted earnings, intensified price competition, and resulted in sizable premium discounts to encourage customer retention in 2021.

The increase in economic activity and normalisation of claims experience over 2021 has placed technical margins under threat as under-priced business earns out. Insurers that have not adequately reflected increasing claims activity into their pricing approach face the threat of technical margin erosion over the near term.

While the pandemic has contributed to pricing pressure, premium rate adequacy has been of concern in the GCC for some time and has in the past attracted regulatory oversight and intervention. Certain regulators have taken steps to support price adequacy in recent years. In Saudi Arabia, technical pricing requirements have been implemented, and the authorities in the

UAE have introduced minimum tariffs on highly competitive classes of business (including motor business). In general, AM Best has observed improvements in insurers' underwriting discipline and pricing tools following these regulatory developments. However, if minimum pricing standards are not enforced, further pricing pressure and competition across the region is likely. Therefore, concerns regarding rate adequacy are set to persist.

In AM Best's view, in order to achieve sustainable, good underwriting performance in these highly competitive segments, insurers will need to balance the benefits of retaining business volumes with maintaining adequate premium rates over the near term.

Level of IFRS 17 Preparedness Uncertain

Preparedness for the implementation of IFRS 17 is also a key challenge over the near term for insurers in the GCC that report under International Financial Reporting Standards. The level of preparedness differs significantly by country and by insurer, however, a key risk for the region in general is the reliance upon regulatory bodies and third-party consultants, where knowledge is concentrated, to drive IFRS 17 development and implementation projects. The subsequent disconnect between internal management and external consultant experience, ahead of the implementation date on 1 January 2023, is a headwind.

Longer Term Operational and Economic Challenges on the Horizon

By and large, the countries of the GCC have demonstrated their continuing economic reliance on hydrocarbon prices over the past 18 months. Although rallying oil prices are supporting economic recovery, AM Best notes that the member states of the GCC, and the insurers that operate in them, will need to adapt and manage the longer-term transition risk presented by global commitments to reduce dependence on petrochemicals and the diversification of economic revenue streams to non-hydrocarbon sources.

While economic transition is a longer-term consideration, the diversification of fiscal revenues presents near-term operational considerations for insurers. In attempts to reduce the fiscal reliance on hydrocarbons, more countries in the region have begun establishing new revenue streams including the introduction of, and in certain cases, increases in the existing rates of Value Added Tax (VAT), while the UAE has announced plans to introduce corporation tax from mid-2023. Actions such as these present operational risks for insurers that must be managed over the course of their implementation periods.

GUIDE TO BEST'S MARKET SEGMENT OUTLOOKS

Our market segment outlooks examine the impact of current trends on companies operating in particular segments of the insurance industry over the next 12 months. Typical factors we would consider include current and forecast economic conditions; the regulatory environment and potential changes; emerging product developments; and competitive issues that could impact the success of these companies. Best's ratings take into account the manner in which companies manage these factors and trends.

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BEST'S MARKET SEGMENT REPORT

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